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No. 91-1368

In the Supreme Court of the United States

OCTOBER TERM, 1991

CHARLES H. FALK AND JOAN FALK AND
HILARY P. GARDNER AND JUDITH C. GARDNER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the Tax Court has jurisdiction to apply the doctrine of equitable recoupment.

2. Whether the courts below properly declined to apply the doctrine of equitable estoppel against the government in the instant case.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A8) is reported at 954 F.2d 836. The opinion of the Tax Court (Pet. App. A26-A42) is unofficially reported under the caption *Fox* v. *Commissioner*, 56 T.C.M. (CCH) 863. The supplemental opinion of the Tax Court is unofficially reported under the caption *Kazi* v. *Commissioner*, 61 T.C.M. (CCH) 1759 (1991).

JURISDICTION

The judgment of the court of appeals was entered on January 22, 1992. The petition for a writ of certiorari was filed on February 21, 1992. The juris-

diction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. From 1975 through 1977, petitioners Charles H. Falk and Hilary P. Gardner participated in commodities tax straddle transactions on the London Metal Exchange.[1] Petitioners stipulated that their transactions were of the same type as the London option straddle transactions that were held to be shams, devoid of economic substance, in *Glass* v. *Commissioner*, 87 T.C. 1087 (1986) (Pet. App. A4).[2] Petitioners' transactions were designed to yield putative "ordinary loss[es]" in the first year, which could be deducted against unrelated ordinary income, and approximately equal offsetting "long-term capital gain[s]" in the second year (Pet. App. A30-A33). Because these transactions lacked economic substance, the Commissioner disallowed the deductions resulting from the claimed "losses" and determined deficiencies in Mr. Falk's 1975-1978 tax years and in Mr. Gardner's 1975-1977 tax years (*id.* at A26-A28).

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[1] Mrs. Falk and Mrs. Gardner are petitioners by virtue of their filing joint returns with their husbands (Pet. App. A29).

[2] *Glass* v. *Commissioner* is the caption of some 1400 consolidated cases. Appeals from *Glass* have now been heard by nine courts of appeals, each of which has affirmed the Tax Court decision. See *Dewees* v. *Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Friedman* v. *Commissioner*, 869 F.2d 785 (4th Cir. 1989); *Killingsworth* v. *Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Ratliff* v. *Commissioner*, 865 F.2d 97 (6th Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988); *Kielmar* v. *Commissioner*, 884 F.2d 959 (7th Cir. 1983); *Lee* v. *Commissioner*, 897 F.2d 915 (8th Cir. 1989); *Keane* v. *Commissioner*, 865 F.2d 1088 (9th Cir. 1989); *Bohrer* v. *Commissioner*, 945 F.2d 344 (10th Cir. 1991); and *Kirchman* v. *Commissioner*, 862 F.2d 1486 (11th Cir. 1989).

Petitioners contended that, as commodities dealers, they were entitled to deduct the putative losses under Section 108 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 630-631, as amended by Section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2817-2818 (Section 108), even though the transactions lacked economic substance. As amended, Section 108(a) provides that losses attributable to the disposition of one leg of a commodity straddle are deductible if incurred in a "trade or business" or in a "transaction entered into for profit." Section 108(b), as amended, provides that a "loss incurred by a commodities dealer * * * shall be treated as a loss incurred in a trade or business" (Pet. App. A83 n.7). Relying on Section 108, petitioners and others similarly situated sought a redetermination of the deficiency asserted against them for their straddle transactions. The Tax Court rejected this contention, holding that Section 108(b) does not allow putative losses incurred in prearranged transactions that lack economic substance to be deducted (Pet. App. A33-A40). The Third Circuit affirmed the Tax Court decision (939 F.2d 44 (1991)), and this Court denied certiorari (112 S. Ct. 590 (1991)).

2. To implement the Tax Court's rulings, the Commissioner filed proposed computations of deficiencies pursuant to Tax Court Rule 155. Petitioners objected to the computation of their deficiencies for 1975, contending for the first time that, under the doctrines of equitable recoupment and equitable estoppel, the deficiencies attributable to the disallowed straddle "losses" in 1975 should be offset by the taxes petitioners allegedly paid on straddle "gains" reported in 1979. Petitioners sought to rely upon these equita-

ble theories because a suit for refund of the 1979 taxes was then barred by the statute of limitations.

On January 30, 1991, the Tax Court rejected petitioners' proposed computation of their 1975 deficiencies in a decision entered under the caption of *Kazi* v. *Commissioner*, 61 T.C.M. (CCH) 1759 (1991). The court noted that "[i]t is well established that as a court of limited jurisdiction we cannot expand our jurisdiction by granting equitable relief" (Pet. App. A21). The court declined to reduce the 1975 deficiencies by the amount of taxes petitioners allegedly paid on corresponding fictitious straddle gains reported in 1979, a year barred by the statute of limitations, holding that the Tax Court "does not have equitable recoupment jurisdiction" (Pet. App. A22).

3. On appeal, the Second Circuit found the taxpayers' arguments to be "without merit" and affirmed (Pet. App. A1-A8). The same Tax Court decision was appealed by another party to the Third Circuit, which affirmed the Tax Court decision by judgment order. *Massy* v. *Commissioner*, 950 F.2d 723 (3d Cir. 1991).[3]

ARGUMENT

The court of appeals correctly concluded that the Tax Court lacks jurisdiction to apply the doctrine of equitable recoupment and that the Commissioner is not equitably estopped from asserting the deficiencies in this case. The decision of the court of appeals does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

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[3] A petition for a writ of certiorari from that decision (*Lerman* v. *Commissioner*, No. 91-1369) is currently pending before the Court.

1. The doctrine of equitable recoupment allows a court of proper jurisdiction to permit a party "litigating a tax claim in a timely proceeding * * * [to] seek recoupment of a related, and inconsistent, but time-barred claim relating to the same transaction." *United States* v. *Dalm*, 494 U.S. 596, 608 (1990). Since this Court's decision in *Commissioner* v. *Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943), however, it has been established that the jurisdiction of the Tax Court is strictly limited by statute, that that court has no authority to enlarge upon that stautory grant of jurisdiction, and that the Tax Court has no jurisdiction to apply the doctrine of equitable recoupment. *Id.* at 420-422. See, *e.g.*, *Commissioner* v. *McCoy*, 484 U.S. 3, 6-7 (1987) (per curiam); *Knapp* v. *Commissioner*, 867 F.2d 749, 754 (2d Cir. 1989); *Phillips Petroleum Co.* v. *Commissioner*, 92 T.C. 885, 888 (1989).

In *Gooch Milling*, the taxpayer had overpaid its taxes for its 1935 fiscal year because it had made an erroneous valuation of its inventory that year. On the basis of the corrected inventory valuation the following year, the Commissioner asserted a deficiency against the taxpayer for its 1936 fiscal year taxes. The taxpayer filed a petition for redetermination of the deficiency asserted against it for 1936 with the Board of Tax Appeals (the predecessor of the Tax Court) and sought to offset the 1935 overpayment against the 1936 deficiency. At that time, Section 272(g) of the Internal Revenue Code of 1939 (26 U.S.C. (1952)) (the predecessor of Section 6214(b) of the current Code) provided that, while the Board could consider facts relating to other years when redetermining a deficiency, the Board had "no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid."

Interpreting that provision, this Court held that the Board lacked jurisdiction to apply the doctrine of equitable recoupment (320 U.S. at 420). The Court noted (*id.* at 420-421):

> The redetermination of the tax liability for the 1936 fiscal year was in no way dependent on any prior tax assessment or overpayment. Likewise, neither the fact that the prior overpayment could no longer be refunded nor the fact that the overpayment exceeded the amount of the deficiency had any relevance whatever to the redetermination of the correct tax for the 1936 fiscal year.

The Court concluded that equitable recoupment is not available in proceedings before the Board because (*id.* at 422):

> The Internal Revenue Code, not general equitable principles, is the mainspring of the Board's jurisdiction. Until Congress deems it advisable to allow the Board to determine the overpayment or underpayment in any taxable year other than the one for which a deficiency has been assessed, the Board must remain impotent when the plea of equitable recoupment is based upon an overpayment or underpayment in such other year.

Following *Gooch Milling*, courts have consistently held that the Tax Court lacks jurisdiction to apply equitable recoupment. In *Rothensies* v. *Electric Storage Battery, Co.*, 329 U.S. 296 (1946), this Court, citing *Gooch Milling*, stated that "the Tax Court has no jurisdiction to consider recoupment" and that, therefore, "the availability of [that] remedy would depend on diverting the litigation to the district courts." *Id.* at 303. Accord, *Continental Equities, Inc.* v. *Commissioner*, 551 F.2d 74, 82-84 (5th Cir. 1977); *Estate of Schneider* v. *Commissioner*, 93 T.C. 568, 570 (1989); *Phillips Petroleum Co.*, 92 T.C. at

889-890. The decision of the court of appeals in the present case is consistent with this uniform line of authority.

Petitioners err in contending (Pet. 12-18) that *United States* v. *Dalm*, *supra*, casts doubt on this long line of authority. While the Court observed in *Dalm* that it did not need to reach the question whether the taxpayer could have raised a recoupment claim in the Tax Court in that case (494 U.S. at 611 n.8), the Court did not intimate that it disagreed with the well-settled state of the law on this issue. Instead, the Court observed (494 U.S. at 610 (emphasis added)):

> Our holding today does not leave taxpayers in Dalm's position powerless to invoke the doctrine of equitable recoupment. Both the Secretary, at the administrative level, * * * *and a court which has jurisdiction over a timely suit for refund* may consider an equitable recoupment claim for an earlier tax paid under an inconsistent theory on the same transaction.

Equitable recoupment has been allowed by this Court only in courts whose jurisdiction is not restricted in the manner of the Tax Court. See *Bull* v. *United States*, 295 U.S. 247 (1935) (suit brought in the Court of Claims); *Stone* v. *White*, 301 U.S. 532 (1938) (suit brought in federal district court).

Petitioners' reliance (Pet. 17-18) on Justice Stevens' dissent in *Dalm* is equally unavailing. Justice Stevens stated that the holding in *Gooch Milling* that equitable recoupment was not available in the Tax Court was limited to the situation that existed in that case, where the recoupment claim was based on an overpayment of taxes in a year *other than the year in dispute* in the Tax court proceeding. 494 U.S. at 61 n.3. Justice Stevens pointed out, by con-

trast, that the taxpayer in *Dalm* sought recoupment with respect to overpayments made *during the same tax year* as the year in dispute. *Ibid.* The present case, however, involves alleged overpayments arising in a different year than the year of the deficiencies, as was the case in *Gooch Milling*, not an overpayment arising in the same tax year, as in *Dalm*. Thus, the distinction between *Dalm* and *Gooch Milling* that Justice Stevens draws in his dissent in *Dalm* is not applicable to the present case.

Nor is there merit in petitioners' further argument (Pet. 18 n.10, 42-43) that the Tax Court has jurisdiction under Section 6214(b) of the Internal Revenue Code—the successor to the provision this Court construed in *Gooch Milling*—to offset the taxes allegedly paid on the sham straddle gains in a year not before the Tax Court against the deficiency determined for a year that is before the court. To be sure, as petitioners contend (Pet. 43), Section 6214(b) allows the Tax Court to "consider such facts with relation to the taxes for other years * * * as may be necessary correctly to redetermine the amount of such deficiency." 26 U.S.C. 6214(b). An example of such a situtation is where the court must determine the proper computation of a net operating loss carryover. See, *e.g.*, *Lone Manor Farms, Inc.* v. *Commissioner*, 61 T.C. 436 (1974), aff'd in an unpublished opinion, 510 F.2d 970 (3d Cir. 1975). Net operating loss carryovers obviously require the court to examine the facts relating to the year in which the loss arose or was claimed, which may not be a year before the court, as a preliminary step in determining the correct amount of a net operating loss carryover to the taxable year in issue.

By contrast, no fact pertaining to petitioners' 1979 year, which was not before the court, is "necessary"

for determination of the deficiencies in petitioners' 1975 tax liabilities. The 1975 deficiencies were determined simply by disallowing the sham straddle losses that petitioners deducted on their 1975 returns. It is not necessary to know the amount of gain improperly included in income in 1979 to determine the amount of loss improperly claimed in 1975. In attempting to blur the distinction between the two separate years, petitioners ignore the well-settled principle that our tax system operates on an annual accounting basis and not on a transactional basis. See *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365-366 (1931); *Hillsboro Nat'l Bank* v. *Commissioner*, 460 U.S. 370, 377-380 & n.10 (1983); *Landreth* v. *Commissioner*, 859 F.2d 643, 649 (9th Cir. 1988). Thus, as in *Gooch Milling*, petitioners seek to offset an alleged overpayment from a year not before the Tax Court against a deficiency determined in a year properly before that court. Just as the petitioner in *Gooch Milling* was barred from doing so by Section 272(g) of the Internal Revenue Code of 1939, so are petitioners here barred from doing so by Section 6214(b) of the current Code.[4]

2. Petitioners contend in the alternative (Pet. 54-60) that the Commissioner should be equitably estopped to deny the sham ordinary loss deductions they claimed in 1975 since petitioners had reported and paid taxes on the sham capital gains in 1979. According to petitioners, "it would be inequitable to

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[4] We note that taxpayers are not necessarily without recourse when a refund is barred by the statute of limitations. Under appropriate circumstances, taxpayers may seek relief from the bar of the statute of limitations under the mitigation provisions of the Internal Revenue Code, Sections 1311 *et seq.* See *United States* v. *Dalm*, 494 U.S. at 610.

find a deficiency which took no note of such erroneous inclusion of income" (Pet. 56).

The traditional elements of equitable estoppel in an action involving private parties are (1) a misrepresentation by the party against whom estoppel is asserted; (2) reasonable reliance on that misrepresentation; and (3) detriment to the other party. *Heckler* v. *Community Health Services of Crawford County, Inc.*, 467 U.S. 51, 59 (1984). Where, as here, estoppel is sought against the government, a far more stringent standard is applied. At a minimum, there must be affirmative misconduct on the part of government agents that significantly imperils the "interest of citizens in some minimum standard of decency, honor, and reliability in their dealings with their Government." *Id.* at 61. Although this Court has not flatly ruled out the possibility of estoppel against the government under any circumstances, it has yet to decide a case sustaining estoppel against the government. *E.g.*, *Heckler* v. *Community Health Services*, 467 U.S. at 60; *OPM* v. *Richmond*, 110 S. Ct. 2465 (1990); *Federal Crop. Ins. Corp.* v. *Merrill*, 332 U.S. 380, 383 (1947).

There is, in any event, no basis for invocation of equitable estoppel against the Commissioner in the instant case. There has been no misrepresentation by the Commissioner or his agents, and petitioners have pointed to none. There has been no reliance by petitioners on any such asserted misrepresentation by the Commissioner or his agents. Petitioners cannot, and do not, claim to have detrimentally relied on any representation by the Commissioner or his agents. Finally, petitioners allege no "affirmative misconduct" by the Commissioner or his agents that would amount to a fraud on the taxpayers' rights. To the

contrary, the Commissioner consistently has maintained that petitioners' straddle transaction losses *and* gains were shams, and he placed petitioners on notice of that position in the statutory notice of deficiency. There is thus no basis for a claim of estoppel in this case, and certainly not for a claim of estoppel against the government.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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